Client planning scenario

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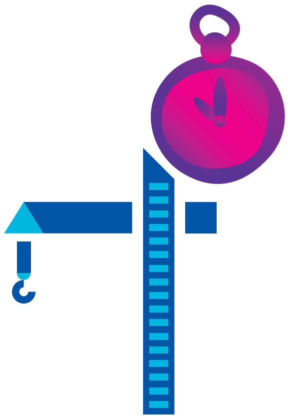

Clients looking to extract profits from a business tax efficiently

Changes to dividend taxation introduced from 6 April 2016 mean that small business owners and entrepreneurs who pay themselves through dividends could face higher tax bills and lower take-home earnings.

This example explains how a Venture Capital Trust (VCT) can be used to extract surplus money from a business tax efficiently.

octopus investments

A brighter way

About this scenario

This tax-planning scenario is designed to help advisers develop appropriate planning strategies for their clients. Advisers should consider, among other things, the eligibility and timings of tax reclaims and tax liabilities depicted. They will also need to consider the impact of charges (including initial fees and ongoing fees, such as administration fees and annual management charges) relevant to the products represented and/or any specific product chosen. When clients choose to sell VCT shares, they are often sold at a small discount to the value of their underlying net asset value, so the impact of this should also be considered when assessing any specific products.

Nothing here should be viewed as advice. Any suitability decisions should be based on a comprehensive review of your client's objectives, needs and attitude towards risk. For more details, please see the relevant product literature.

Meet Vijay, a small business owner

Vijay is an independent IT contractor. Because he works as a consultant for a number of different companies, he has established a limited company. Vijay's company chooses to pay him a salary of £11,500 per year – which is tax free, as it sits within his personal allowance. In addition to his tax-free salary, after a particularly profitable year for the company, Vijay also stands to receive a £70,000 dividend. £5,000 of this is tax free thanks to the new dividend allowance. The next £28,500 is taxed at the basic rate of 7.5% (tax liability of £2,137.50), and the remaining £36,500 is taxed at the higher rate of 32.5% (tax liability of £11,862.50). This equates to a tax bill of £14,000.

A tax-planning solution from Octopus

Vijay talks to his financial adviser, who makes an assessment based on his risk profile, investment time horizon (of more than five years) and attitude towards smaller company investing. Given this, his adviser suggests investing in a VCT.

In the two decades since they were first introduced, VCTs have become increasingly popular with some investors, particularly those who already have personal pensions and Individual Savings Accounts (ISAs), and are comfortable with higher risk investments. They are proving even more popular with individuals like Vijay, following recent changes to dividend taxation.

With a VCT, Vijay can claim up to 30% income tax relief on up to £200,000 invested in any single tax year, provided he holds his VCT shares for at least five years. Vijay can also benefit from tax-free dividends and no capital gains tax to pay when he sells the shares.

An important reminder about key risks

VCTs are high risk and should be considered as long-term investments. The value of an investment, and any income from it, can fall or rise. Investors may not get back the full amount they invest.

Tax treatment depends on individual circumstances and can change in the future. Tax reliefs also depend on the VCT maintaining its qualifying status. Tax relief is available on investments of up to £200,000 per year.

VCT shares could fall or rise in value more than other shares listed on the main market of the London Stock Exchange. They may also be harder to sell.

These products are not suitable for everyone.

The tax benefits of investing dividends in a VCT

This diagram shows how a small business owner can take advantage of the tax benefits associated with investing in a VCT to offset their dividend tax bill. VCTs are high risk and if an investor needs guaranteed income, cannot tolerate loss or is uncomfortable losing immediate access to their money, then a VCT will not be suitable. Clearly everyone's circumstances are different, and VCTs won't be suitable for all, but the attractive tax benefits mean that VCTs could be considered as part of a portfolio for some people.

Vijay

£70,000
dividend paid out with part used as income and part placed into a savings account

£70,000
dividend paid out with part used as income and part invested into a VCT

£46,667
invested in a VCT

£23,333
remaining in cash

£14,000
dividend tax due on the initial £70,000 extracted

£14,000
30% tax relief on VCT

£56,000
remaining after tax in addition to Vijay's £11,500 tax-free salary

£70,000
remaining after tax, £23,333 can be used to provide immediate income in addition to Vijay's £11,500 tax-free salary

For Vijay, who is comfortable living off a net income of £2,903 per month after tax, investing the rest of his dividend for a minimum of five years in a VCT offers Vijay the ability to increase the net earnings from his dividend by 26%.

Note: For purposes of this illustrative example, we have assumed no gain or loss on investments, and it does not take into account any initial fees or ongoing charges that will be incurred. VCTs are high risk and inherently different from pensions and ISAs. When clients choose to sell VCT shares, they are often sold at a small discount to the value of their underlying net asset value, so the impact of this should also be considered when assessing any specific products. Please note, after selling shares in a VCT, it is not possible to claim tax relief on new shares bought in the same VCT within six months of the initial sale.

Octopus – an investment company with a difference

When we launched Octopus in 2000, our ambition was to create a different type of financial services company. We wanted to be known for putting our customers first.

Today, Octopus is an investment company with more than 500 employees and more than £7.2 billion in funds under management (source: Octopus, June 2017). We work with tens of thousands of clients, and we've built market-leading positions in tax-efficient investment, smaller company financing, renewable energy and healthcare. But no matter how big we get, our aim is to keep doing the simple things well and to look after each of our customers, day in, day out.

Our products are not suitable for everyone. Any recommendation should be based on a holistic review of your client's financial situation, objectives and needs. We do not offer investment or tax advice, but we recommend investors seek professional advice. Before investing in a VCT, investors should read the product prospectus and Key Information Document (KID).

Why not look through some of our other tax-planning scenarios?

- Clients who are looking to extract money from a pension tax efficiently
- Clients who are additional rate tax payers
- Clients looking to set up a trust
- Clients caught in the 'ISA as inheritance' trap
- Clients who want to reduce their income tax bill

For a copy, or to find out more about Octopus and what we do:

Call our Business Development Managers on **0800 316 2067**
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